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Doubts Raised on Big Backers of Mortgages

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As home prices continue their free fall and banks shy away from lending, Washington officials have increasingly relied on two giant mortgage companies — Fannie Mae and Freddie Mac — to keep the housing market afloat.

But with mortgage defaults and foreclosures rising, Bush administration officials, regulators and lawmakers are nervously asking whether these two companies, would-be saviors of the housing market, will soon need saving themselves.

The companies, which say fears that they might falter are baseless, have recently received broad new powers and billions of dollars of investing authority from the federal government. And as Wall Street all but abandons the mortgage business, Fannie Mae and Freddie Mac now overwhelmingly dominate it, handling more than 80 percent of all mortgages bought by investors in the first quarter of this year. That is more than double their market share in 2006.

But some financial experts worry that the companies are dangerously close to the edge, especially if home prices go through another steep decline. Their combined cushion of $83 billion — the capital that their regulator requires them to hold — underpins a colossal $5 trillion in debt and other financial commitments.

The companies, which were created by Congress but are owned by investors, suffered more than $9 billion in mortgage-related losses last year, and analysts expect those losses to grow this year. Fannie Mae is to release its latest financial results on Tuesday and Freddie Mac is to report earnings next week.

The companies are sitting on as much as $19 billion in additional losses that they have not yet fully acknowledged, analysts say. If either company stumbled, the mortgage business could lose its only lubricant, potentially causing the housing market to plummet and the credit markets to freeze up completely.

And if Fannie or Freddie fail, taxpayers would probably have to bail them out at a staggering cost.

“We’ve taken tremendous risks by loosening these companies’ purse strings,” said Senator Mel Martinez, Republican of Florida and a former secretary of housing and urban development. “They could cause an economywide meltdown if they got into real trouble and leave the public on the hook for billions.”

Concerns over the companies’ finances have prompted a fierce behind-the-scenes battle between nervous government officials and the two companies. Bush administration officials, the Federal Reserve and lawmakers all believe that the companies’ financial safety cushion is far too thin and have pleaded with them to raise more capital from investors.

Freddie and Fannie, which are enjoying new growth and profits, have largely resisted those pleas, people briefed on the talks say, because selling new shares could dilute the holdings of existing shareholders and drive down their stock prices. Though executives have promised to raise money this year, they refuse to specify how much and when.

Moreover, the companies are using their newfound clout to push Congress and their regulator to roll back the limits that were imposed after recent scandals over accounting and executive pay, according to participants in those conversations.

More Capital Sought

As a result, high-ranking government officials are now quietly threatening to publicly criticize the two companies if they do not soon raise large amounts of capital, people with firsthand knowledge of those threats say. William Poole, a president of a Federal Reserve bank who has since retired, has warned that companies like Fannie Mae and Freddie Mac are "at the top of my list of sources of potentially serious trouble."

A report last month by the agency overseeing the companies said that they pose "significant supervisory concerns" and that Freddie Mac suffers "internal control weaknesses."

Lawmakers are pushing to rein in the companies with new legislation. Senator Christopher J. Dodd, the Connecticut Democrat who leads the Banking Committee, will soon take up legislation giving the government broad authority over the companies. Lawmakers say it is likely a bill will pass this year.

"They are on real thin ice financially," said Senator Richard C. Shelby of Alabama, the senior Republican on the Banking Committee. "And the way the law is written right now, there is very little we can do to correct that."

The companies say such criticisms are without merit. Their latest regulatory filings, they note, show a combined financial safety net that exceeds required minimums by $7 billion. The companies raised $13 billion from investors last year and say any future losses will be offset by new revenue and by money they have already set aside.

Criticisms Rejected

"The irony is that right now I'm seeing the best opportunities since I've been in this business," said Daniel H. Mudd, chief executive of Fannie Mae, in an interview conducted last month.

The companies also say that they have not demanded anything. Rather, they say, the limitations have been dropped because of the companies' commitment to financial transparency and aiding the housing recovery.

But others remain concerned. Though the companies' main regulator, James B. Lockhart III, director of the Office of Federal Housing Enterprise Oversight, has voiced strong confidence in the companies, a high-ranking member of his staff said some officials had begun considering the worst.

"It's not irrational to be thinking about a bailout," said that person, who requested anonymity, fearing dismissal.

Fannie and Freddie do not lend directly to home buyers. Rather, they buy mortgages from banks and other lenders, and thereby provide fresh capital for home loans. The companies keep some of the mortgages they buy, hoping to profit from them, and sell the rest to investors with a guarantee to pay off the loan if the borrower defaults.

Because of the widespread perception that the government would intervene if either company failed, they can borrow money at lower interest rates than their competitors. As a result, they have earned enormous profits that have enriched shareholders and managers alike: from 1990 to 2000, each company's stock grew more than 500 percent and top executives were paid tens of millions of dollars.

Those profits were threatened earlier this decade, however, when new competitors emerged and after audits revealed that both companies had manipulated their earnings. The companies were forced to replace top executives, pay hundreds of millions in penalties and consent to strict growth limits.

To keep profits aloft and meet affordable-housing goals set by Congress, the companies began buying huge numbers of subprime and Alt-A mortgages, the highly profitable loans often taken out by low-income and riskier borrowers. By the end of last year, the companies had guaranteed or invested in $717 billion of subprime and Alt-A loans, up from almost none in 2000.

Then the housing bubble burst. In February, the companies revealed a $6 billion combined loss in the fourth quarter of 2007, and both companies' stock prices fell more than 25 percent in less than two weeks. Freddie Mac fell to $17.39 on March 10 from $24.49 on Feb. 28, while Fannie Mae declined to $19.81 on March 10 from $27.90 on Feb. 28.

Despite those troubles, lawmakers had few alternatives to asking Fannie and Freddie to buy more and riskier mortgages.

"I want these companies to help with affordable housing, to help low-income families get loans and to help clean up this subprime mess," said Representative Barney Frank, a Massachusetts Democrat and the chairman of the House Financial Services Committee. "Otherwise, why should they exist?"

Demands for Repeals

But now that the government depends on Fannie and Freddie to keep markets humming, the companies are making demands of their own — namely, repealing some of the limits created after the scandals and even some established by law.

Last year, in return for buying billions of dollars of subprime mortgages to help stabilize the market, executives won the right to expand their investment portfolios. In March, the companies agreed to raise more capital within the year. In exchange, they received an additional $200 billion in purchasing power.

Last month, the companies promised to pump money into the more expensive reaches of the housing market. In return, Congress temporarily raised the cap on the size of the mortgages they can buy to almost $730,000 from $417,000.

"We have to bow and scrape and haggle each time we need help," said a senior Republican Senate assistant who spoke only on the condition of anonymity.

Each time Congress or regulators have given the companies new room for growth, their stock prices have risen. But so far the companies have balked at raising more capital.

That hesitation has lawmakers concerned that when the companies raise money this year, it will not be enough.

In a March meeting, Freddie Mac's chairman, Richard F. Syron, bolstered those fears by saying the company would put shareholders' interests first. Michael L. Cosgrove, a spokesman for Freddie Mac, said Mr. Syron is committed to both satisfying the company's public mission and creating shareholder value. Fannie Mae, which is in a regulatory-imposed quiet period because it will soon release financial information, declined to comment on capital-raising issues.

As worrisome as the need for new capital, some analysts say, are the companies' books.

A report released earlier this month by Mr. Lockhart, the regulator, noted that although Freddie and Fannie had a combined $19.9 billion of "unrealized losses" on mortgage-related investments, neither company had reduced its earnings to reflect those declines. That is because they judged the losses to be temporary — in essence wagering that the mortgage market would recover before those assets were sold. Such a wager is permitted by the rules but difficult for outsiders to analyze.

Fannie Mae declined to discuss unrealized losses. Mr. Cosgrove, the Freddie Mac spokesman, said the company discloses all financial choices and downgrades all potentially impaired securities when appropriate.

The regulator's report also noted that Freddie used accounting choices that gave it an immediate $1 billion capital increase. While those and other tactics are technically permitted, the regulator said, they deserve scrutiny.

"Companies can make assumptions that cause very large differences in what they report," Mr. Lockhart said in an interview. He has repeatedly said that the companies are making good progress and have fixed many of their problems. But at least one accounting choice, he said, "concerns us."

Mr. Cosgrove said Freddie Mac's accounting choices had been the best way to reflect financial realities.

Both companies have also recently changed their policies on delinquent loans, which they previously recorded as impaired when borrowers were 120 days late. Now, some overdue loans can go two years before the companies record a loss.

Fannie Mae declined to discuss the accounting of impaired loans. A representative of Freddie Mac said marking loans as permanently impaired at 120 days does not reflect that many of them avoid foreclosure. But the biggest risk, analysts say, is that both companies are betting that the housing market will rebound by 2010. If the housing malaise lasts longer, unexpected losses could overwhelm their reserves, starting a chain of events that could result in a federal bailout.

A version of those events began in November, when Freddie Mac's capital fell below congressionally mandated levels. The company stemmed the decline by selling $6 billion in preferred stock. But it might not manage that again if there is another unexpected loss, analysts say.

“The last two years have shown the real need for a stronger regulator,” Mr. Lockhart said. If his agency did not curb the companies’ growth earlier this decade, he added, “they would be part of the problem right now instead of part of the solution.”